

VI. WASTEWATER

A. Introduction

The City of San Diego's Metropolitan Wastewater Department (the "MWWD") provides sewage services to residents and businesses within San Diego, as well as to 15 neighboring municipalities known as Participating Agencies (or "PA's"). The MWWD currently has three treatment facilities for sewage waste treatment.⁷¹⁴ These treatment plants require routine maintenance and improvements which the City has largely funded with state and federal grants and loans. To date, the City has received at least 18 grants and loans in the amount of approximately \$265 million to subsidize the cost of various wastewater construction projects.⁷¹⁵

The City contracts with the State (as administrator of the federal assistance program) for these funds, and in doing so it expressly agrees to comply at all times with certain federal and state laws and other guidelines (the "Guidelines").⁷¹⁶ The Guidelines are promulgated by the State Water Resources Control Board (the "SWRCB") as the fund program administrator, and are designed to interpret and implement Clean Water Act requirements.⁷¹⁷ From at least 1995 to 2004, the City was out of compliance with these requirements, and as a result was in violation of its grant and loan covenants. Compliance would have reduced residential users' rates at the same time that it raised rates for a company called CP Kelco ("Kelco") and other industrial users. Accordingly, the City's violation resulted in the City's residential users subsidizing the rates of its industrial ones. As a result of the City's violation, the City risked having to repay all of the grants and loans it had received.

Although the City issued sewer revenue bonds no less than three times during the course of its decade of noncompliance, and had planned a fourth issuance, there is no evidence it made any effort to disclose to the investing public either that it was violating the terms of its agreements with the State, or that, as a result, there was a potentially significant liability.⁷¹⁸ Many of the individuals within the City who knew about the noncompliance and its potential financial ramifications were the same people who had direct responsibility for preparing and/or ensuring the accuracy of the disclosures.⁷¹⁹ It seems clear, however, they

⁷¹⁴ The City's three wastewater treatment plants are Point Loma Wastewater Treatment Plant, North City Water Reclamation Plant, and South Bay Water Reclamation Plant. *See* 2002 Annual Financial Report of the City of San Diego Metropolitan Wastewater Utility for Fiscal Year Ended June 30, 2002, at 6-7 (Dec. 2002).

⁷¹⁵ *See* Appendix K for a table reflecting the City's grants and loans received under the Clean Water Act program.

⁷¹⁶ *See, e.g.* Contract No. 00-826-550-0, Loan No. C-06-4718-110, Exhibit G, art. 2. (May 8, 2001).

⁷¹⁷ SRF Revenue Program Guidelines at 1 (May 10, 1988).

⁷¹⁸ E-mail from Paul Maco to Paul Webber (Feb. 12, 2004).

⁷¹⁹ Required Items for Wastewater System Preliminary Official Statement (Sorted by Responsible Party) (Dec. 2, 1998).

failed in their responsibility to do so. More than failing to make the requisite disclosures, in some instances it appears the City may have gone further, and made conscious efforts to mislead both investors and rating agencies.⁷²⁰ Whether intentional or just sloppy, this potentially significant liability was not addressed in either the City's or the MWWD's annual financial statements, although it should have been.⁷²¹

The City's response to the need to change its rate structure is yet another thread in its deeply woven pattern of hiding "bad facts" for as long as it could get away with it. It was not until 2004 when the State formally demanded that the City change its rate structure that the necessary action was taken.⁷²²

B. Regulatory Requirements

The United States Environmental Protection Agency ("EPA") established a grant and loan program under the Clean Water Act to assist municipalities with various capital improvement projects. The State of California participates in the program by contributing funds toward the projects.⁷²³ The SWRCB is the State agency tasked with administering the program on behalf of the EPA and the State. To obtain and keep its grant and loan money, the City must comply with the requirements of the Clean Water Act and the SWRCB's mandatory Guidelines which expand on the Clean Water Act.⁷²⁴

With respect to rate setting, the Clean Water Act requires that no grant shall be approved unless the City "has adopted or will adopt a system of charges to assure that each recipient of waste treatment services . . . will pay its proportionate share" of the City's costs to treat the wastewater.⁷²⁵ Federal regulations provide that this "proportionate share" must be "based on the user's proportionate contribution to the total

⁷²⁰ E-mail from Dennis Kahlie to Ted Bromfield, Eric Adachi, Clay Bingham, and Bill Hanley (July 1, 2003); E-mail from Bill Hanley to Mark Capell, Dennis Kahlie, and Eric Adachi (July 1, 2003); Interview by the Audit Committee with Bill Hanley (Apr. 25, 2006).

⁷²¹ As discussed in more detail below, the City was required to disclose in its financial statements "[m]aterial violations of finance-related legal and contractual provisions." National Council on Governmental Accounting, Interpretation 6, Notes to the Financial Statements Disclosure at ¶ 4 (May 1982).

⁷²² Letter from Dennis H. Kahlie, Utilities Finance Administrator, to Ronald R. Blair, Sanitary Engineering Associate, State Water Resources Control Board (June 15, 2004); Letter from Ronald R. Blair, Sanitary Engineering Associate, State Water Resources Control Board, to Michael T. Uberuaga, City Manager (Mar. 17, 2004).

⁷²³ Policy for Implementing The State Revolving Fund for Construction of Wastewater Treatment Facilities at 1 (February 1995) (amended June 18, 1998); Memorandum from Mary Vattimo, City Treasurer, and Kelly J. Salt, Deputy City Attorney, to Honorable Mayor and City Council (Nov. 14, 2002); Interview by the Audit Committee with Richard Enriquez (Apr. 18, 2006).

⁷²⁴ Policy for Implementing The State Revolving Fund for Construction of Wastewater Treatment Facilities at 1, G-1 (February 1995) (amended June 18, 1998). As discussed herein, the City was obligated to comply with the Guidelines under the terms of its contractual agreements with the State.

⁷²⁵ Federal Water Pollution Control Act, Title II § 204 (b)(1), 33 U.S.C.A. § 1284 (2006).

wastewater loading from all users (or user classes).⁷²⁶ The crux of this requirement is that each user must pay his fair share of treatment costs.

The City is subject to a similar proportionality requirement imposed by Proposition 218 (“Prop 218”), a Constitutional amendment passed by California voters in November 1996.⁷²⁷ Prop 218 provides that a fee imposed upon “any parcel or person as an incident of property ownership shall not exceed the proportional cost of the service attributable to the parcel.”⁷²⁸ It also sets forth a procedure for providing voters with notice of rate changes.⁷²⁹ Although there continues to be a question about whether Prop 218 applied to sewer charges, a 2004 California Supreme Court decision suggests that, as to the proportionality requirement, it may.⁷³⁰ Notwithstanding the uncertainty regarding its application, the City opted to comply with Prop 218’s provisions anyway, out of concern for pending and future bond issuances.⁷³¹

Although the Clean Water Act and Prop 218 did not define the means to achieve “proportionality,” the SWRCB Guidelines did.⁷³² The Guidelines required a city first to estimate its total revenue requirements and identify its users’ respective demands on the system.⁷³³ Then the City must allocate the treatment costs “among the treatment parameters (flow, BOD, SS, and other appropriate constituents) in proportion to the percentage of costs that these parameters represent.”⁷³⁴ “Flow” is the amount of wastewater that is discharged; “SS” or “Suspended Solids” refers to the “insoluble solid matter” in wastewater.⁷³⁵ “BOD,” or biochemical oxygen demand, is a measure of wastewater strength, *i.e.*, the amount of organics, or oxygen-

⁷²⁶ 40 C.F.R. § 35.2140(a).

⁷²⁷ Right to Vote on Taxes Act, art. XIII D, § 6 (Nov. 5, 1996).

⁷²⁸ Right to Vote on Taxes Act, art. XIII D, § 6(b)(3) (Nov. 5, 1996).

⁷²⁹ Right to Vote on Taxes Act, art. XIII D, § 6 (Nov. 5, 1996).

⁷³⁰ *Richmond v. Shasta Community Services District*, 32 Cal. 4th 409 (Cal. 2004).

⁷³¹ Memorandum from City Attorney to Honorable Mayor and City Council (Dec. 6, 2001); E-mail from Kelly Salt to Ed Ryan, Dennis Kahlie, Mary Vattimo, Casey Gwinn, Keri Katz, Ted Bromfield, George Loveland, Patricia Frazier, Paul Webber, Bill Hanley, and Scott Tulloch (Oct. 18, 2001).

⁷³² Policy for Implementing The State Revolving Fund for Construction of Wastewater Treatment Facilities at G-1 (February 1995) (amended June 18, 1998).

⁷³³ Policy for Implementing The State Revolving Fund for Construction of Wastewater Treatment Facilities at G-1 (February 1995) (amended June 18, 1998).

⁷³⁴ Policy for Implementing The State Revolving Fund for Construction of Wastewater Treatment Facilities at § 1-4(A)(1) (February 1995) (amended June 18, 1998) (emphasis added).

⁷³⁵ Regional Wastewater Disposal Agreement between the City of San Diego and the Participating Agencies in the Metropolitan Sewage System at 4, 6 (revised Mar. 2, 1998).

consuming bacteria in the wastewater.⁷³⁶ The Guidelines require cities to document their compliant user charge system in a “revenue program” submitted to and approved by the SWRCB.⁷³⁷ As discussed below, the City’s loan agreements with the State required compliance with the Guidelines, and the agreements set forth specific contractual remedies for a breach of any material provision.

The allocation requirement set forth in the Guidelines is at the heart of the City’s noncompliance. Until June 2004, the City set its sewer rates in a manner that only took into account the flow and suspended solids discharged by each user. The City did not consider in these rates the costs associated with removing organics, even though since 1995, it operated under a waiver mandating the removal in specified amounts.⁷³⁸ The waiver was sought in connection with Congress’s enactment of the Ocean Pollution Reduction Act on October 31, 1994, and it required the City to remove not less than 58% of BOD discharge from the City’s Point Loma plant.⁷³⁹ As soon as the City began incurring costs to remove organics from the wastewater, it was obligated to pass those costs on to its users.⁷⁴⁰ From 1995 until 2004, because the City did not bill users in proportion to the costs associated with the removal of organics from its users’ wastewater, it was out of compliance with the Clean Water Act, the SWRCB Guidelines, and, likely, Prop 218.

C. Loan & Grant Covenants

Under the program described above, the City obtains low-interest loans (and previously grants) to support its publicly-owned treatment works. Under the Clean Water Act and California law, the

⁷³⁶ Letter from F.D. Schlesinger, Director, MWWD, to Ronald R. Blair, Revenue Program Specialist, State Water Resources Control Board (May 9, 1995).

⁷³⁷ Policy for Implementing The State Revolving Fund for Construction of Wastewater Treatment Facilities at § 1-1(A), (C), (E) (February 1995) (amended June 18, 1998).

⁷³⁸ Since the adoption of the Clean Water Act in 1972, the Point Loma plant performed only advanced primary treatment on its wastewater, which process did not remove organics from wastewater. The City applied to the EPA for a waiver from secondary treatment between 1979 and 1987 but did not receive a waiver. It withdrew its application for a waiver in 1987. As of the time the City’s waiver application was withdrawn, the City failed to comply with the Clean Water Act’s mandate for secondary treatment. Annual Report for the Fiscal Year Ended June 30, 2003 relating to Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995, Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B, and Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B, at 38 (Mar. 26, 2004).

⁷³⁹ The Act enabled the City to apply for a Treatment Waiver, which it did in April 1995; the Treatment Waiver was granted on November 9, 1995. Annual Report for the Fiscal Year Ended June 30, 2003 relating to Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995, Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B, and Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B, at 38-40 (Mar. 26, 2004).

⁷⁴⁰ Memorandum from Mary Vattimo, City Treasurer, and Kelly J. Salt, Deputy City Attorney, to Honorable Mayor and City Council (Nov. 14, 2002).

City enters into grant and loan contracts with the SWRCB on behalf of the State of California.⁷⁴¹ Each of the loan agreements carries with it several important covenants relevant to the City's obligations to allocate costs in a proportionate manner:⁷⁴²

- Section 17 ("User Charge System"). The City agrees to "adopt and maintain in effect a user charge system which at all times complies with the requirements of Section 204(b)(1) of the federal Clean Water Act and applicable federal and state rules, regulations and guidelines."
- Exhibit G, Article 2 ("Compliance with Laws, Regulations, Etc."). The City must "at all times, comply with . . . all applicable federal and state laws, rules guidelines, regulations, and requirements." The City agrees to comply with the SWRCB Guidelines, to the extent applicable.
- Exhibit G, Article 8 ("Revenue Program"). The City must prepare and submit to the SWRCB an acceptable final revenue program before 90% of the funds on a project are paid out. The City must review and modify its revenue program "as necessary to assure [its] reasonable adequacy," and the program must be "consistent with applicable guidelines."

Each of these loan provisions obligates the City to comply with the SWRCB's Guidelines as a condition of receiving funds under loan agreements with the State. As described above, the Guidelines carry the explicit requirement that the City must bill its users proportionately, which since 1994 meant including a Biological Oxygen Demand ("BOD") or Chemical Oxygen Demand ("COD") treatment parameter in its rate structure.⁷⁴³ By failing to include this parameter, the City violated these covenants in its agreements with the State.⁷⁴⁴ Like the loans, the nine relevant grants for wastewater projects carried similar requirements.⁷⁴⁵

⁷⁴¹ 33 U.S.C. § 1251 (West 2006); California Water Code § 13478 (2006).

⁷⁴² See, e.g., Point Loma Digesters C1 and C2 Agreement, Contract No. 00-826-550-0 (executed May 8, 2001). The numbered provisions quoted herein are from this Agreement. While the other loan contracts contain the same requirements, the provisions may be numbered differently.

⁷⁴³ Policy for Implementing The State Revolving Fund for Construction of Wastewater Treatment Facilities at G-5 (February 1995) (amended June 18, 1998).

⁷⁴⁴ Annual Report for the Fiscal Year Ended June 30, 2003, relating to Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995, Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B, and Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B, at 9 (Mar. 26, 2004); Policy for Implementing the State Revolving Fund for Construction of Wastewater Treatment Facilities at G-5 (February 1995) (amended June 18, 1998).

⁷⁴⁵ Each of the City's grant agreements require the City to comply with a C.F.R. provision obligating the City to, among other things: (1) charge users their proportionate share of costs; (2) submit acceptable proposed revenue programs; (3) enact a sewer use ordinance before the project is placed in operation, and (4) base user charges on such factors such as strength, volume, and delivery flow rate characteristics." 40 C.F.R. §§ 35.929-1(a), 35.2030(b)(3)(vii), 35.2140(a), 35.2208 (2006).

The loan agreements unambiguously set forth the possible ramifications to the City for failing to comply with the loan provisions:

- Exhibit G, Article 12 (“Withholding of Local Match Loan Disbursements”). The SWRCB has the right to “withhold all or any portion” of the loan funds provided for under the agreement if any one of three things occur: (1) the City “has materially violated, or threatens to materially violate, any term, provision, condition, or commitment of this contract”; (2) . . . ; or (3) “An acceptable Revenue Program is not submitted at the time of 90 percent disbursement” of the loan funds.
- Exhibit G, Article 16(A) (“Termination: Immediate Repayment”). At the SWRCB’s option, the contract may be terminated by written notice at any time prior to the complete repayment of the loan, “upon violation by the [City] of any material provision” of the agreement, “after such violation has been called to the attention of the [City] and after failure of the [City] to bring itself into compliance” within a reasonable time.
- Exhibit G, Article 16(B) (“Termination: Immediate Repayment”). If the loan is terminated, the City “agrees, upon demand, to immediately repay to the SWRCB an amount equal to the current balance due” on the loan, and all penalties.

These provisions are contained in each of the City’s nine loan agreements with the State.⁷⁴⁶ The “notice and cure” provision (quoted above at Exhibit G, Article 16 (A)) allows the SWRCB to terminate the contract if a material violation is called to the City’s attention and the City fails to correct it within a reasonable time. Like the loans’ acceleration provision, the grants similarly carry the possibility for immediate repayment of the funds for the City’s failure to comply.⁷⁴⁷ In total, the City has received approximately \$265 million in grants and loans to fund wastewater-related projects (though at the time of its noncompliance it believed the amount to be much higher).⁷⁴⁸ As the City was well aware, its failure to comply with these various grant and loan covenants exposed it to the potential immediate repayment of up to the entire amount of these funds.⁷⁴⁹

⁷⁴⁶ Appendix K contains a list of the City’s relevant grants and loans with the SWRCB.

⁷⁴⁷ State Revolving Fund Local Match Loan Program Contract between the State Water Resources Control Board and the City of San Diego, Local Match Loan No. C-06-4383-110, Ex. G, art. 16(A) and (B), at 20-21 (approved Dec. 28, 1999); Letter from Ronald R. Blair, Sanitary Engineering Associate, to Michael T. Uberuaga, City Manager (Nov. 26, 2003). The Federal regulations provide that “[i]f a recipient materially fails to comply with the terms and conditions of an award, whether stated in a Federal statute, regulation, assurance, application, or notice of award” the EPA may take remedies including withholding of payments pending correction of deficiencies, the partial or entire suspension of the grant, and the disallowance of all or any part of the grant. 40 C.F.R. §§ 30.61, 30.62 (2006). Even once a grant has been closed out, if deficiencies arise, the EPA still has the right to recover funds. 40 C.F.R. § 30.72 (2006).

⁷⁴⁸ The City’s relevant grants and loans with the SWRCB total approximately \$265 million. Appendix K; Memorandum from Mary Vattimo, City Treasurer, and Kelly J. Salt, Deputy City Attorney, to Honorable Mayor

D. Knowing Lack of Compliance

In 1994, when Congress passed the Ocean Pollution Reduction Act, the City's treatment permit requirements changed, and the City started incurring costs to remove organics from its wastewater.⁷⁵⁰ The new law permitted the City to apply for a waiver from the requirement to implement secondary treatment capabilities, i.e., treatment focused on removal of organics, at its main primary treatment plant, Point Loma.⁷⁵¹ However, under the terms of the waiver, the City was still required to improve the treatment capability at Point Loma to remove a minimum of 58% of organics (the biological or chemical oxygen demand) from the wastewater treated there, and not less than 80% of total suspended solids.⁷⁵² The City has estimated it spent approximately \$1 million per year in additional wastewater treatment costs in order to comply with the 58% BOD requirement.⁷⁵³ Because the City began incurring costs in order to remove organics, the obligation to consider the incremental costs for organics removal when setting sewer user rates was triggered.⁷⁵⁴

and City Council (Nov. 14, 2002); E-mail from Maureen Brungardt to Bill Hanley cc to Richard Enriquez (Mar. 15, 2004).

⁷⁴⁹ City Manager's Report No. 92-241 at 3 (July 21, 1992).

Mr. Aguirre reached a similar conclusion and stated in his Wastewater Interim Report No. 1, "The noncompliance of the actual rates charged was a risk to the bond financing because the loan and grants allowed for the State of California to make the City immediately repay the grants and loans received." Wastewater Interim Report No. 1, City of San Diego Officials' Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity, Report of the San Diego City Attorney Michael J. Aguirre, at 10 (Sept. 15, 2005).

⁷⁵⁰ E-mail from Karyn Keese to William Hanley (Sept. 28, 2000) (reporting statement by SWRCB's Ron Blair that "City was first require[d] to include BOD in their rates . . . at the point they took the grant for the accelerated projects at Point Loma").

⁷⁵¹ Letter from Ted Bromfield, Deputy City Attorney, to Hugh Barroll, Esq., Assistant Regional Counsel, U.S. Environmental Protection Agency, and Martin J. McDermott, Esq., Trial Attorney, U.S. Department of Justice cc to F.D. Schlesinger, MWWWD Director, and James J. Dragna, Co-Counsel (Aug. 21, 2000); Interview by the Audit Committee with Ted Bromfield (Apr. 27, 2006); Interview by the Audit Committee with David Schlesinger (Apr. 24, 2006).

⁷⁵² Annual Report for the Fiscal Year Ended June 30, 2003, relating to Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1995, Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B, and Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B, at 39 (Mar. 26, 2004); Interview by the Audit Committee with Ted Bromfield (Apr. 27, 2006); Interview by the Audit Committee with Alan Langworthy (Apr. 19, 2006).

⁷⁵³ Declaration of Christopher J. Toth in Support of Plaintiff's Motion for a Preliminary Injunction at 2, *City of San Diego v. Browner*, No. 00 CV 00436 (S.D. Cal. Mar. 31, 2000).

⁷⁵⁴ Letter from Rod Rippel, Industrial Waste Program Manager, to Frank E. Peters cc to Water Utilities Director, Assistant Water Utilities Director, Deputy Director Services Division, Dennis Kahlie, Deputy Director Metro Division, and Walter Konopka (July 19, 1989).

In late 1994, the SWRCB learned that the City was not taking into account the incremental costs associated with removing organics when billing its neighboring municipalities – the PA's.⁷⁵⁵ On September 30, 1994, the SWRCB program administrator Ronald Blair sent a letter to City Manager Jack McGrory and directed the City to comply with the Guidelines by incorporating a COD component into the PA's sewer rates.⁷⁵⁶ Mr. Blair said nothing about how the City billed its own residents because he had assumed (incorrectly) that the City's sewer rates for its own citizens already complied with the Guidelines.⁷⁵⁷ The City did nothing to correct Mr. Blair's mistaken impression, responding that it would change its PA's rates to bring them into compliance.⁷⁵⁸ Although the topic was surely ripe for discussion, the City failed to mention to Mr. Blair that its own users were being charged in the same flawed manner as the PA's.⁷⁵⁹ It was obvious that it was only because of Mr. Blair's misunderstanding that he did not also direct the City to change its own users' rates. This was the first of many occasions when the City allowed Mr. Blair's misunderstanding to persist while the City remained mute. Even absent a specific instruction to change its own users' rates in 1994, the City got the message loud and clear that the change was necessary.⁷⁶⁰

The City began taking steps in 1997 to change its own and its PA's sewer rates to include a COD parameter, further reinforcing that it knew it was out of compliance.⁷⁶¹ On July 3, 1997, Patricia Frazier, then the City's Financial and Technical Services Manager, wrote to Deputy City Manager Coleman Conrad: "In order to comply with SWRCB Revenue Program Guidelines, we will need to revise our methodology for strength based billing of [the City's] customers. . . . Pursuant to SWRCB guidelines, we will

⁷⁵⁵ Memorandum from Ronald R. Blair, Revenue Program Specialist, State Water Resources Control Board, to Dick Wasser, Chief, Construction Monitoring Unit, Division of Clean Water Programs (Sept. 28, 1994).

⁷⁵⁶ Letter from Ronald R. Blair, Revenue Program Specialist, to Jack McGrory, City Manager (Sept. 30, 1994).

⁷⁵⁷ E-mail from Dennis Kahlie to Ed Ryan, George Loveland, Kelly Salt, Mary Vattimo, Patricia Frazier, and Richard Mendes (Nov. 13, 2002); Dennis Kahlie, Salient Points, Sewer Cost of Service Compliance Issue at 2-3 (Nov. 13, 2002); Interview by the Audit Committee with Ronald Blair (Sept. 27, 2005).

⁷⁵⁸ Letter from F.D. Schlesinger, Director, MWWD, to Ronald R. Blair, Revenue Program Specialist, State Water Resources Control Board (May 19, 1995).

⁷⁵⁹ Letter from F.D. Schlesinger, Director, MWWD, to Ronald R. Blair, Revenue Program Specialist, State Water Resources Control Board (May 19, 1995); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁶⁰ E-mail from Dennis Kahlie to Ed Ryan, George Loveland, Kelly Salt, Mary Vattimo, Patricia Frazier, and Richard Mendes (Nov. 13, 2002); Memorandum from Patricia T. Frazier, Financial and Technical Services Manager, to Coleman Conrad, Deputy City Manager (July 3, 1997); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁶¹ Memorandum from William J. Hanley, III, Deputy Metropolitan Wastewater Director, Services & Contracts, to Coleman Conrad, Deputy City Manager, MS 9A (Aug. 8, 1997).

need to incorporate a third loading factor – COD/BOD.”⁷⁶² By that time, the City understood its failure to include an organics component in its rate structure was not just a violation of SWRCB Guidelines, but also a violation of the Clean Water Act’s requirements of “fair and equitable billing.”⁷⁶³ To address the issue, Mr. Conrad forwarded Ms. Frazier’s memo to then-Water Department Director George Loveland, who later became a Deputy City Manager.⁷⁶⁴ The task then fell to Deputy MWWDD Director William Hanley to implement a compliant rate structure by FY 1999.⁷⁶⁵

To assist it in revising its rate structure, the City retained an outside consultant, PinnacleOne (“Pinnacle”), to perform a Cost of Service Study (“COSS”).⁷⁶⁶ A COSS is a study conducted by experts to examine various aspects of a city’s rate structure, and it can be an expensive and time-consuming endeavor.⁷⁶⁷ Pinnacle completed its final report on May 14, 1998, and like the other studies that followed it, Pinnacle confirmed what the City already knew about its need to change its rate structure to comply with SWRCB requirements.⁷⁶⁸ The study stated: “Adopting a user charge system based on strength-based billing is not only a condition for retention of previously awarded grant funds under the EPA program, but it is a requirement for future funding under California’s State Revolving Fund for Construction of Wastewater Treatment Facilities.”⁷⁶⁹ This knowledge, however, did not appear to alter the City’s behavior in any discernable way.

E. A Study in Delay

By May 1998, the City had both the knowledge it was not in compliance with the SWRCB requirements and a consultant’s report making plain how to fix the problem. After paying \$150,000 to those

⁷⁶² Memorandum from Patricia T. Frazier, Financial and Technical Services Manager, to Coleman Conrad, Deputy City Manager (July 3, 1997).

⁷⁶³ Minutes, Sewer Classification Meeting (Mar. 18, 1997) (“The meeting took place in response to the need to implement Strength Based Billing (SBB) [defined in the minutes as billing on flow, TSS and COD] with City of San Diego Municipal customers as well as Participating Agencies (PAs).”).

⁷⁶⁴ Handwritten Memorandum from Coleman Conrad to Dave Schlesinger and George Loveland cc to Pat Frazier (July 9, 1997).

⁷⁶⁵ Memorandum from William J. Hanley, III, Deputy Metropolitan Wastewater Director, Services & Contracts, to Coleman Conrad, Deputy City Manager, MS 9A (Aug. 8, 1997).

⁷⁶⁶ Agreement between the City of San Diego and High-Point Rendel for the Preparation of a Sewer Cost-of-Service Study and a Water Cost-of-Service Study (1996). “A management buyout in 1997 of High Point Rendell’s North American operation resulted in the formation of PinnacleOne.” <http://www.pinnacleone.com/about/history.aspx>.

⁷⁶⁷ Interview by the Audit Committee with Bill Hanley (April 25, 2006); Interview by the Audit Committee with Sudhir Pardiwala (June 6, 2006).

⁷⁶⁸ City of San Diego Sewer Cost-of-Service Report prepared by PinnacleOne for the City of San Diego, Financing Services at 1 (May 14, 1998).

⁷⁶⁹ City of San Diego Sewer Cost-of-Service Report prepared by PinnacleOne for the City of San Diego, Financing Services at 2 (May 14, 1998).

consultants,⁷⁷⁰ the City shelved the report, and then spent the next six years ignoring its obligations and trying to keep its compliance failures from the public domain.⁷⁷¹

In Fall 1999, Councilmember Christine Kehoe learned the City had completed the COSS nearly a year and one-half earlier and was doing nothing with it.⁷⁷² She was troubled that residential customers were subsidizing industrial users by virtue of the City's failure to comply with the proportionate billing requirements.⁷⁷³ Her questions regarding the City's foot-dragging were provided to Patricia Frazier.⁷⁷⁴ Ms. Frazier's answers to Councilmember Kehoe's questions were false and misleading. Although the Pinnacle study clearly stated that revising the rate structure was a mandatory condition of the City's grants and loans, and notwithstanding the fact that the study made no mention of Prop 218, Ms. Frazier responded that "the reports did not justify changing the rate structure . . . [and the purpose of the study was] to simply justify our existing structure [and] to make sure that we were complying with Prop 218."⁷⁷⁵

Deputy City Manager George Loveland formally distributed this one and one-half year-old study to the Mayor and the City Council, seemingly in response to Councilmember Kehoe's questions. Mr. Loveland's cover memo transmitting the study was similarly deceiving. He stated: "Our conclusion, based on the studies and extensive internal review, was and is that the . . . sewer rate structures adopted by the Council are both business-friendly and consistent with the requirements of Proposition 218. This being the case, no changes are needed or recommended at this time."⁷⁷⁶

In an apparent effort to pacify Councilmember Kehoe,⁷⁷⁷ City Manager Michael Uberuaga agreed to update the May 1998 study and to have that study reviewed by a citizens "stakeholders group"

⁷⁷⁰ Sewer/Water Cost of Service Study (undated document).

⁷⁷¹ E-mail from Dennis Kahlie to Ted Bromfield, Eric Adachi, Clay Bingham, and Bill Hanley (July 1, 2003); E-mail from Bill Hanley to Mark Capell, Dennis Kahlie, and Eric Adachi (July 1, 2003); Memorandum from City Attorney to Eric Adachi, City Rate Analyst, Jenna Magan, Bond Counsel, and Bill Hanley, MWWDD Deputy Director (Apr. 24, 2003); Memorandum from Ted Bromfield, Deputy City Attorney, to Councilmember Christine Kehoe (Draft Nov. 1999); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁷² E-mail from Christine Ruess to Dennis Kahlie and Mary Vattimo (Oct. 20, 1999); Interview by the Audit Committee with Christine Ruess (May 10, 2006).

⁷⁷³ E-mail from Christine Ruess to Dennis Kahlie (Oct. 20, 1999).

⁷⁷⁴ E-mail from Christine Ruess to Dennis Kahlie (Oct. 20, 1999).

⁷⁷⁵ E-mail from Christine Ruess to Dennis Kahlie (Oct. 20, 1999); Interview by the Audit Committee with Christine Ruess (May 10, 2006).

⁷⁷⁶ Memorandum from George Loveland, Deputy City Manager, to Honorable Mayor and City Council (Oct. 6, 1999).

⁷⁷⁷ Sewer Cost of Service Stakeholders' Group Final Report, September 14, 2000-May 3, 2001 at 3 (undated) ("At the request of former City Council Member Christine Kehoe, former Mayor Susan Golding appointed a group of individuals representing a range of interests, both residential and business, to serve on a committee that would make recommendations to City staff about the rate structure and associated elements.").

whose members were to be appointed by Mayor Susan Golding.⁷⁷⁸ A full year passed, however, before the “stakeholders group” was actually formed. The holdup was reportedly caused by a delay by the Mayor’s office in selecting group members.⁷⁷⁹ Once the group was finally underway, the City did not direct the group to opine on whether the City needed to include a COD parameter in its rate structure, since that was undisputed.⁷⁸⁰ Indeed, the introduction to the “Sewer Cost of Service Stakeholders’ Group Final Report September 14, 2000-May 3, 2001” states that the City had “limited discretion in rate-setting” in light of its receipt of grants and loans from the federal government.⁷⁸¹ It later states that, “[b]oth because of the permit requirements and the City’s obligations to SWRCB, City staff does not have the discretion to base rates on only SS and flow.”⁷⁸² Therefore, the group was charged with making a recommendation to the City Council about allocation, and specifically about how costs should be allocated among the three different components, including COD.⁷⁸³

Ultimately, the stakeholders group reached a stalemate on the issue of allocation methodology, and was unable to make any recommendation.⁷⁸⁴ Opportunities for consensus were opposed by David McKinley, a Kelco representative whose company stood to lose as much as three or four million dollars per year if the rates were changed.⁷⁸⁵ Mr. McKinley continually questioned whether including an organics component in the rate structure was truly necessary and, assuming it was, he championed methodologies that

⁷⁷⁸ E-mail from Dennis Kahlie to George Loveland, Pat Frazier and Mary Vattimo (Nov. 3, 1999); Sewer Cost of Service Stakeholders’ Group Final Report, September 14, 2000-May 3, 2001, at 3 (undated).

⁷⁷⁹ Dennis Kahlie, Salient Points, Sewer Cost of Service Compliance Issue at 3 (Nov. 13, 2002); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁸⁰ E-mail from Sudhir D. Pardiwala to Kathy Hancock, Dennis Kahlie, and Sara M. Katz (Aug. 2, 2000); E-mail from Sudhir D. Pardiwala to Patricia Tennyson, Laurie Schaffer, and Dennis Kahlie (July 24, 2000); Interview by the Audit Committee with Karyn Keese (May 10, 2006).

⁷⁸¹ Sewer Cost of Service Stakeholders’ Group Final Report, September 14, 2000-May 3, 2001, at 2 (undated).

⁷⁸² Sewer Cost of Service Stakeholders’ Group Final Report, September 14, 2000-May 3, 2001, at 9 (undated).

⁷⁸³ E-mail from Sudhir D. Pardiwala to Kathy Hancock, Dennis Kahlie, and Sara M. Katz (Aug. 2, 2000); E-mail from Sudhir D. Pardiwala to Patricia Tennyson, Laurie Schaffer, and Dennis Kahlie (July 24, 2000); Interview by the Audit Committee with Karyn Keese (May 10, 2006).

⁷⁸⁴ Sewer Cost of Service Stakeholders’ Group Final Report, September 14, 2000-May 3, 2001, at 9 (undated).

⁷⁸⁵ Letter from David McKinley, Environmental Manager, San Diego Plant, to Bill Hanley, Deputy Director, Services and Contracts, cc to George I. Loveland, Deputy City Manager, Dave Schlesinger, Director, Metropolitan Wastewater Department (“MWWD”), Susan C. Hamilton, Assistant Director, MWWD, Alan Langworthy, Deputy Director, MWWD, Hedy Griffiths, MWWD, Monica Ramos, MWWD, Eric Adachi, Economist, Financing Services, Dennis Kahlie, Rate Analyst, Financing Services, Nicholas B. Wiseman, President, Monsanto-Kelco, Stephen A. Zapoticzny, Director, Environmental, Safety and Health, Monsanto-Kelco, Gregory D. Kurdys, Plant Manager - San Diego, Monsanto-Kelco (Dec. 14, 1998); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005); Interview by the Audit Committee with Karyn Keese (May 10, 2006).

would result in the lowest cost to Kelco.⁷⁸⁶ When the group finally issued its report in May 2001, the City was no further along in achieving compliance than it had been years before.⁷⁸⁷

F. A Fair Warning

Following the issuance of the Stakeholders Report, the City received yet another COSS, this one by a firm called Black & Veatch (“B&V”). The B&V study, completed on or about May 15, 2002, unremarkably reached the same conclusion as the 1998 Pinnacle study: “As a recipient of various federal grants and state loans, the City is obligated to comply with SWRCB’s Revenue Program Guidelines. In order to be consistent with the Revenue Program requirements, SWRCB is mandating that the City modify its existing cost allocation basis and include the Chemical Oxygen Demand (COD) parameter in its rate structure.”⁷⁸⁸

With the B&V study substantially completed, describing in clear language both the City’s obligation to have a compliant sewer rate structure and the methodology to put that structure in place, the matter of the City’s sewer rates was raised before the City Council in closed session on January 29, 2002.⁷⁸⁹ The closed session was called for the purpose of discussing whether the City would continue to comply with the noticing and proportionate billing requirements of Prop 218.⁷⁹⁰ Following that discussion, Dennis Kahlie of Financing Services told the Council that the City was not complying with a condition of its wastewater grants and loans because its sewer rates did not meet SWRCB requirements.⁷⁹¹ Mr. Kahlie explained that if the City did not comply, the SWRCB had the right to demand the return of the City’s grants and accelerate the loans.⁷⁹² Mr. Kahlie further informed the Council that although compliance with SWRCB requirements

⁷⁸⁶ Letter from David McKinley, Environmental Manager, San Diego Plant, to Bill Hanley, Deputy Director, Services and Contracts, cc to George I. Loveland, Deputy City Manager, Dave Schlesinger, Director, Metropolitan Wastewater Department (“MWWD”), Susan C. Hamilton, Assistant Director, MWWD, Alan Langworthy, Deputy Director, MWWD, Hedy Griffiths, MWWD, Monica Ramos, MWWD, Eric Adachi, Economist, Financing Services, Dennis Kahlie, Rate Analyst, Financing Services, Nicholas B. Wiseman, President, Monsanto-Kelco, Stephen A. Zapotieczny, Director, Environmental, Safety and Health, Monsanto-Kelco, Gregory D. Kurdys, Plant Manager - San Diego, Monsanto-Kelco (Dec. 14, 1998); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005); Interview by the Audit Committee with Karyn Keese (May 20, 2006).

⁷⁸⁷ Interview by the Audit Committee with Karyn Keese (May 10, 2006).

⁷⁸⁸ Black & Veatch, Sewer Cost of Service and Rate Design Report at ES-1 (Jan. 15, 2002); Interview by the Audit Committee with Sudhir Pardiwala (June 6, 2006).

⁷⁸⁹ City of San Diego City Council Closed Session Report (Jan. 29, 2002); Black & Veatch, Sewer Cost of Service and Rate Design Report at ES-1 (Jan. 15, 2002); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁹⁰ E-mail from Dennis Kahlie to Ed Ryan, George Loveland, Kelly Salt, Mary Vattimo, Patricia Frazier, and Richard Mendes (Nov. 13, 2002).

⁷⁹¹ E-mail from Dennis Kahlie to Ed Ryan, George Loveland, Kelly Salt, Mary Vattimo, Patricia Frazier, and Richard Mendes (Nov. 13, 2002); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

were revenue neutral – they would neither increase nor decrease the total amount of revenue received by the City from sewer rates – compliance would result in increased sewer rates for large organics dischargers and lower rates for low dischargers.⁷⁹³

Mr. Kahlie recalled that Mayor Murphy asked him if the SWRCB was demanding the City to make the change immediately.⁷⁹⁴ Mr. Kahlie responded that it was not currently asking, but certainly would at some point. According to Mr. Kahlie, he reminded the City Council it was contractually obligated to impose a compliant rate structure, to which Councilmember James Madaffer responded, “Let ‘em sue us!”⁷⁹⁵

Mr. Kahlie’s recollection of the Council’s response to his presentation was substantially corroborated by an e-mail sent shortly after the presentation from Councilmember Madaffer to Mr. Kahlie, copied to Mr. Uberuaga, stating:

I wanted to thank you for your presentation today in closed session. *Despite my comments and that of others, I wanted to commend you for your direct answers and sticking to your position.* Let’s hope we don’t hear back from you on this issue, but if we do, I know we’ll have good advice and *we can’t say we weren’t given a fair warning.*⁷⁹⁶

The Mayor and all of the members of the City Council were present for Mr. Kahlie’s presentation – Council members Madaffer, Maienschein, Wear, Inzunza, Frye, Atkins, and Stevens – with the exception of Scott Peters.⁷⁹⁷ Also present were Deputy City Attorney Kelly Salt, City Manager Michael Uberuaga, Deputy City Manager George Loveland, City Attorney Casey Gwinn, Executive City Attorney Leslie Devaney, Assistant City Attorney Leslie Girard, City Auditor Ed Ryan, and Utilities Director Richard Mendes.⁷⁹⁸ The formal action taken by the City Council was to “note and file,” effectively a decision to table

⁷⁹² E-mail from Dennis Kahlie to Ed Ryan, George Loveland, Kelly Salt, Mary Vattimo, Patricia Frazier, and Richard Mendes (Nov. 13, 2002); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁹³ Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁹⁴ Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁹⁵ E-mail from Les Girard to Dennis Kahlie cc to Patricia Frazier and Mary Vattimo (Apr. 15, 2004); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁷⁹⁶ E-mail from Jim Madaffer to Dennis Kahlie cc to Michael Uberuaga (Jan. 29, 2002) (emphasis added).

⁷⁹⁷ San Diego City Council Closed Session Report (Jan. 29, 2002).

⁷⁹⁸ San Diego City Council Closed Session Report (Jan. 29, 2002).

the issue indefinitely, and to request further review of the issue by the City Attorney's Office.⁷⁹⁹ Councilmembers Donna Frye and George Stevens voted against simply "noting and filing" the matter.⁸⁰⁰

Being rebuffed by the City Council did not deter Mr. Kahlie. On February 1, 2002, he e-mailed City Treasurer Mary Vattimo and Deputy City Manager for Finance Patricia Frazier with the following warning:

Bill Hanley dropped by for a chat this morning. *He's got a total of \$41 million in new SRF grant applications pending with the state water resources control board (SWRCB), all of which carry the requirement for adoption of rate structures recovering costs on a basis proportionate to use. The first thing that will happen when SWRCB finds out that the council doesn't care to live up to its contractual obligations with respect to ratesetting is that these applications will be disapproved.*

I've been doing research in support of Kelly's task of assessing non-compliance risk for the council. As I see it, *failure to recover costs proportionate to use puts us in breach of a total of eight previously executed grant/loan contracts worth \$410 million. As to when the hammer drops, it could literally happen at any time after SWRCB concludes the City has begun to drag its feet.*

. . . [I]t's not likely that it can be suppressed for long.

Sorry, but there it is.⁸⁰¹

Several months after the closed session, Councilmember Frye made efforts to have this issue brought to the public's attention.⁸⁰² She believed the citizens had a right to know that the City possessed a study telling the City that it was not in compliance with the SWRCB requirements and that as a result residential users were paying more to subsidize industry.⁸⁰³ On May 14, 2002, in an open session meeting regarding the MWWd's and Water Department's budgets, Councilmember Frye asked the Mayor about the status of the sewer COSS and when it might be released to the public.⁸⁰⁴ After a long and awkward pause by Mayor Murphy – possibly attributable to the fact that it had only been raised in closed session – she

⁷⁹⁹ San Diego City Council Closed Session Report (Jan. 29, 2002).

⁸⁰⁰ San Diego City Council Closed Session Report (Jan. 29, 2002).

⁸⁰¹ E-mail from Dennis Kahlie to Mary Vattimo and Patricia Frazer (Feb. 1, 2002) (emphasis added).

⁸⁰² Interview by the Audit Committee with Councilmember Donna Frye (Sept. 14, 2005); Videotape, San Diego City Council Budget Hearing (May 14, 2002).

⁸⁰³ Interview by the Audit Committee with Councilmember Donna Frye (Sept. 14, 2005).

⁸⁰⁴ Interview by the Audit Committee with Councilmember Donna Frye (Sept. 14, 2005); Videotape, San Diego City Council Budget Hearing (May 14, 2002).

incorrectly added that she had been at a public meeting of the Council regarding sewer rates where the sewer COSS had been discussed.⁸⁰⁵ The Mayor denied that was correct and said that while the water COSS was discussed, he did not recall the Council discussing the sewer COSS at a public meeting.⁸⁰⁶ He then noted that a sewer COSS had been discussed informally by the City Council. George Loveland confirmed that a water COSS was underway.⁸⁰⁷ He made no mention that multiple sewer COSS's had been conducted.⁸⁰⁸

Although a legal opinion was requested in January 2002, the City Attorney's Office did not formally respond for nearly ten months. On November 14, 2002, Ms. Salt and Ms. Vattimo submitted a formal memorandum to the Mayor and City Council, recommending the City bring its sewer rates into compliance with its grant and loan conditions (the "November 14, 2002 Memo").⁸⁰⁹ This memorandum was scheduled to be taken up by the City Council in closed session on November 19, 2002.⁸¹⁰

Like the 1998 Pinnacle study and the 2002 B&V study, the Salt and Vattimo Memorandum to the Mayor and City Council again told the City that it was required to change its sewer rate structure and repeated that the City's failure to do so placed it in breach of hundreds of millions of dollars of grants and loans:

In sum, the City currently has approximately \$370 million in outstanding loans and grants related to improving the Metropolitan Wastewater System. A condition of those grants and loans is that the City's user fees and charges be "proportionate." . . . Failure to comply with these conditions and requirements may result in litigation for the repayment of the grant monies and acceleration of the repayment of loan monies. Additionally, failure to comply may result in the loss of future State Revolving Fund [SRF] loan monies.

. . . .

Currently, the City's user charge system does not comply with the Clean Water Act.⁸¹¹

⁸⁰⁵ Interview by the Audit Committee with Councilmember Donna Frye (Sept. 14, 2005); Videotape, San Diego City Council Budget Hearing (May 14, 2002).

⁸⁰⁶ Interview by the Audit Committee with Councilmember Donna Frye (Sept. 14, 2005); Videotape, San Diego City Council Budget Hearing (May 14, 2002).

⁸⁰⁷ Videotape, San Diego City Council Budget Hearing (May 14, 2002).

⁸⁰⁸ Videotape, San Diego City Council Budget Hearing (May 14, 2002).

⁸⁰⁹ Memorandum from Mary Vattimo, City Treasurer, and Kelly J. Salt, Deputy City Attorney, to Honorable Mayor and City Council (Nov. 14, 2002).

⁸¹⁰ Memorandum from City Attorney to Charles G. Abdelnour, City Clerk (Nov. 14, 2002).

⁸¹¹ Memorandum from Mary Vattimo, City Treasurer, and Kelly J. Salt, Deputy City Attorney, to Honorable Mayor and City Council (Nov. 14, 2002).

The memorandum warned the Mayor and City Council of the consequences of their failure to bring the City's sewer rates into compliance:

Each of the loan contracts permits immediate[] acceleration of loan repayments by the City upon breach of the contract. Thus, if [the] acceleration provision is invoked, the City could be required to immediately repay all of the outstanding loans. Additionally, the federal and state governments could conceivably request repayment of the grants received by the City if the City is found to have been out of compliance with grant requirements.

Finally, in any litigation concerning the loan contracts, the prevailing party is entitled to receive attorney fees and costs.⁸¹²

Mr. Kahlie had planned to attend the scheduled November 19, 2002 closed session meeting to personally deliver the substance of the Salt and Vattimo Memorandum.⁸¹³ Just before the closed session was to take place, likely at Ms. Frazier's request, Mr. Kahlie prepared an outline that summarized the pertinent issues.⁸¹⁴ The document was entitled "Salient Points, Sewer Cost of Service Compliance Issue" (the "Salient Points Memo"), and the file name of the document indicates that it was intended to brief the Mayor.⁸¹⁵ A draft of Mr. Kahlie's Salient Points Memo was distributed to Ed Ryan, George Loveland, Kelly Salt, Mary Vattimo, Patricia Frazier, and Richard Mendes.⁸¹⁶ The Salient Points Memo further quantified the serious consequences of continuing to refuse to comply with the SWRCB requirements:

A decision which results in the repayment of the previously received grants and accelerated repayment of the existing and in-process SRF loans would require the issuance of approximately \$403 million in new sewer revenue bonds having an annual debt service cost approximating \$28 million per year for 30 years. Servicing this new debt . . . would require that FY 2003 rates be increased by an additional 52.5 percentage points above the 7.5% increase authorized by the Council in October of 2001 – a 60% increase in a single year.⁸¹⁷

⁸¹² Memorandum from Mary Vattimo, City Treasurer, and Kelly J. Salt, Deputy City Attorney, to Honorable Mayor and City Council (Nov. 14, 2002).

⁸¹³ E-mail from Patricia Frazier to Dennis Kahlie (Nov. 18, 2002).

⁸¹⁴ E-mail from Dennis Kahlie to Pat Frazier attaching Salient Points Sewer Cost of Service Compliance Issue (Nov. 18, 2002); Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁸¹⁵ E-mail from Dennis Kahlie to Mary Vattimo, Kelly Salt, George Loveland, Patricia Frazier, Richard Mendes, Eric Adachi, and Ed Ryan, attaching Salient Points Sewer Cost of Service Compliance Issue (Nov. 13, 2002).

⁸¹⁶ E-mail from Dennis Kahlie to Mary Vattimo, Kelly Salt, George Loveland, Patricia Frazier, Richard Mendes, Eric Adachi, and Ed Ryan, attaching Salient Points Sewer Cost of Service Compliance Issue (Nov. 13, 2002).

⁸¹⁷ Dennis Kahlie, Salient Points, Sewer Cost of Service Compliance Issue at 2 (Nov. 13, 2002).

Kahlie's Salient Points Memo described the role politics played in the earlier administration's failure to comply with the City's legal obligations:

The municipal billing structure was not brought into compliance with SWRCB requirements in 1997 because of concerns about the adverse impact of so doing on certain large volume dischargers of organics in a then-soft economy. SWRCB did not take issue with this situation because it was under the mistaken impression that the PA billing structure it had approved was applicable to the City's municipal users as well.⁸¹⁸

Mr. Kahlie concluded it would take three to six months to update the COSS and present a revised rate structure to the City Council for adoption, meaning the City had the ability to bring itself into compliance by February or March 2003.⁸¹⁹

Receipt of the Salt and Vattimo Memorandum caused Councilmember Frye again to object to shrouding the City's lack of compliance in secrecy. She voiced to the City Attorney her view that it was improper to discuss this matter in closed session.⁸²⁰ Councilmember Frye's objections did not result in an open airing of the matter. Assistant City Attorney Leslie Girard responded to Councilmember Frye that the wastewater rate structure was properly addressed in closed session because it "relates to the City's liability should the City Council not undertake to review and approve a cost of service study."⁸²¹ Mr. Girard continued, "a decision is not being made in closed session regarding the proposed study, we are merely advising on the litigation risk in the event a [sic] appropriate study is not brought forward for action. Any action regarding the proposed study will be taken in open session, if at all."⁸²² Mr. Girard closed his letter to Councilmember Frye with an explanation that "there may not be sufficient time to address this issue" at the November 19th closed session.⁸²³ Notwithstanding the clear warning provided to the Mayor and City Council of the need to address this matter, following Councilmember Frye's objections the matter was taken off the closed session agenda for November 19, 2002, and never rescheduled.

By January 2003, the City Manager's Office began updating the COSS again. Mr. Loveland sent an e-mail to this effect to the Utilities Department and the Mayor's Office, stating: "[W]e are

⁸¹⁸ Dennis Kahlie, Salient Points, Sewer Cost of Service Compliance Issue at 2-3 (Nov. 13, 2002).

⁸¹⁹ Dennis Kahlie, Salient Points, Sewer Cost of Service Compliance Issue at 4 (Nov. 13, 2002).

⁸²⁰ Letter from Councilmember Donna Frye to City Attorney Casey Gwinn (Nov. 18, 2002). Councilmember Frye's concerns about whether this matter was properly discussed in closed session were shared by Executive Assistant City Attorney Leslie Devaney. Interview by the Audit Committee with Leslie Devaney (April 18, 2006).

⁸²¹ Memorandum from Leslie J. Girard, Assistant City Attorney, to Councilmember Donna Frye (Nov. 18, 2002).

⁸²² Memorandum from Leslie J. Girard, Assistant City Attorney, to Councilmember Donna Frye (Nov. 18, 2002).

⁸²³ Memorandum from Leslie J. Girard, Assistant City Attorney, to Councilmember Donna Frye (Nov. 18, 2002).

proceeding with the sewer cost of service study. We estimate that it will take 6 months and approximately \$75k to complete. . . When finished it will be docketed for Council consideration.”⁸²⁴ Although by Mr. Loveland’s estimates the update was supposed to be completed by July 2003, it was not finished until October 2003. And instead of it being docketed for Council consideration, the study was forwarded to yet another “stakeholders group” of sorts, a sub-committee of the City’s Public Utilities Advisory Commission.⁸²⁵

Like the stakeholders group formed three years before – indeed, including an overlap of some of the members – the Public Utilities Advisory Commission sub-committee was tasked with making rate recommendations to the full Commission, which would then make a recommendation to City Council.⁸²⁶ One member who served on each of the two groups thought it accurate to describe the experience as “déjà vu.”⁸²⁷ Kelco, who had turned up the heat years before, had its same representative as well as a professional lobbyist again make presentations before the new committee.⁸²⁸ Kelco made the identical arguments it made years before, and by all accounts, its opposition efforts appeared to be leading the group to the same stalemate it reached in 2001.⁸²⁹

As the subcommittee was struggling with the rate issues in November 2003, Mr. Kahlie called Ronald Blair to tell him that, unless the SWRCB effectively forced the City’s hand and demanded that it change its rate structure, Mr. Kahlie did not believe the issue would ever be resolved.⁸³⁰ Mr. Kahlie referred to this as requesting a “line in the sand” letter from the State.⁸³¹ According to Mr. Blair, it was only in this conversation with Mr. Kahlie that he became aware that the City was not already charging its users for organics.⁸³² Mr. Kahlie was also of the view that the State was misled as to the City’s compliance, stating in

⁸²⁴ E-mail from George Loveland to Richard Mendes and John Kern (Jan. 22, 2003).

⁸²⁵ Memorandum from Patricia T. Frazier, Deputy City Manager, to Honorable Mayor and City Council (Oct. 17, 2003).

⁸²⁶ Agenda, City of San Diego Public Utilities Advisory Commission Joint Public Meetings of Water & Wastewater O & M Committee and Water & Wastewater Service Delivery Committee Concerning City of San Diego Water and Sewer Rates (Apr. 5, 2004); Agenda, Public Utilities Advisory Commission (Nov. 17, 2003); E-mail from Dennis Kahlie to Christine Ruess, Charles Yackly, Marsi Steirer, and Sam Gray (Jan. 15, 2003); E-mail from Marsi Steirer to Christine Ruess and Dennis Kahlie (July 23, 2002).

⁸²⁷ Interview by the Audit Committee with Karyn Keese (May 10, 2006).

⁸²⁸ E-mail from Dave Schlesinger to Scott Tulloch (Aug. 12, 2003); E-mail from Dennis Kahlie to Patricia Tennyson (Aug. 11, 2003).

⁸²⁹ E-mail from Dave Schlesinger to Scott Tulloch (Aug. 12, 2003); E-mail from Marsi Steirer to Christine Ruess and Dennis Kahlie (July 23, 2002).

⁸³⁰ Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁸³¹ Interview by the Audit Committee with Dennis Kahlie (Oct. 18, 2005).

⁸³² Interview by the Audit Committee with Ronald Blair (Sept. 27, 2005).

2000 that Mr. Blair was “confused” about what the City was actually charging its users.⁸³³ Mr. Kahlie also observed in his Salient Points memo described above that the SWRCB had been “under the mistaken impression that the PA billing structure it had approved was applicable to the City’s municipal users as well.”⁸³⁴ And, Mr. Blair’s own communications with the City indicate confusion about whether the City was already charging its users for COD. For example, Mr. Blair sent Mr. Kahlie a letter on June 22, 2001, which described his understanding of “[t]he City’s *current* user charge system.”⁸³⁵ He believed it included an allocation of costs to BOD for “*all users in the city and participating agencies.*”⁸³⁶

The evidence as to whether the State had in fact been misinformed about the City’s compliance, however, is mixed. Notwithstanding Mr. Blair’s and Mr. Kahlie’s recollections, there is evidence that Mr. Blair was informed in 1998 that the City was not billing its users based on organics.⁸³⁷ According to the City’s consultant, B&V, since at least 2000 there is no question Mr. Blair knew the City was out of compliance.⁸³⁸ Significantly, notwithstanding the differing recollections about Mr. Blair’s knowledge, Mr. Blair did not believe the City actively misled him, and there is little evidence showing otherwise.⁸³⁹ It is nonetheless clear that for at least some period of time City officials were aware of Mr. Blair’s confusion and did nothing to correct it.

In response to Mr. Kahlie’s phone call to Mr. Blair, Mr. Blair wrote to Mr. Uberuaga on November 26, 2003, and diplomatically stated that the SWRCB was unable to find any documentation in its files showing the City had implemented a compliant rate structure.⁸⁴⁰ The letter reminded the City it was

⁸³³ E-mail from Patricia Tennyson to Sudhir D. Pardiwala, Dennis Kahlie, Eric Adachi, Hedy Griffiths, and Bill Hanley (Oct. 2, 2000) (“Blair is confused about what was included in the revenue plans submitted by the City and the PAs.”).

⁸³⁴ E-mail from Dennis Kahlie to Ed Ryan, George Loveland, Kelly Salt, Mary Vattimo, Patricia Frazier, and Richard Mendes (Nov. 13, 2002).

⁸³⁵ Letter from Ronald R. Blair, Revenue Program Specialist, to D.H. Kahlie (June 22, 2001) (emphasis added).

⁸³⁶ Letter from Ronald R. Blair, Revenue Program Specialist, to D.H. Kahlie (June 22, 2001) (emphasis added).

⁸³⁷ In a December 30, 1998 e-mail from Hedy Griffiths to Bill Hanley stamped “BUSINESS SENSITIVE” and entitled “SWRCB- Ron Blair and Kelco [sic],” Ms. Griffiths wrote that she “just spoke with Ron” about conversations he had with Kelco. She wrote that Blair “thought [Kelco was] currently being charged at a higher rate for BOD, I told him we’re still on TSS and Flow for Municipal customers.” Mr. Blair did not recall this conversation with Ms. Griffiths, nor did he recall being told that the City was not charging its own users for COD. Interview by the Audit Committee with Ronald Blair (Sept. 27, 2005).

⁸³⁸ Interview by the Audit Committee with Sudhir Pardiwala (June 6, 2006).

⁸³⁹ Interview by the Audit Committee with Ronald Blair (Sept. 27, 2005).

⁸⁴⁰ Letter from Ronald R. Blair, Sanitary Engineering Associate, to Michael T. Uberuaga, City Manager (Nov. 26, 2003).

obliged to maintain a sewer rate structure that complied with Clean Water Act regulations as a condition of its federal grants and state loans, and requested that the City *within 90 days* submit the ordinance which enacted appropriate rates. The City responded to the SWRCB's letter on January 8, 2004, conceding that as a result of changes in administration and "objections on the part of some wastewater dischargers, municipal compliance is not yet an accomplished fact."⁸⁴¹ The City said it would not be able to meet the SWRCB's 90-day timeframe, but was committed to a Council hearing on the issue in 2004.⁸⁴² On March 17, 2004, the SWRCB responded to the City's letter, stating "revised rates must be implemented for the 2004-2005 fiscal year" and the City had 90 days to submit an adopted ordinance or resolution calling for a revised rate structure.⁸⁴³

As a result of Mr. Blair's demand, on June 8, 2004, the City Council was presented with a resolution revising the existing wastewater fees and charges to bring the City into full compliance with the SWRCB's requirements.⁸⁴⁴ The City Manager recommended to the City Council that it adopt the resolution,⁸⁴⁵ while Kelco and others strongly urged against its adoption.⁸⁴⁶ The resolution described that the new rate structure would "result in increases in the Fees for certain sewer customers," and it scheduled the new compliant rate structure to become effective on October 1, 2004.⁸⁴⁷ The resolution, a concession by the City Council to Kelco, directed the City Manager "to investigate and evaluate programs [for] funding incentives to significant sewer dischargers of [COD]."⁸⁴⁸ The City Council ultimately approved the resolution by a vote of 9 to 0, at last closing the chapter of the City's long story of noncompliance.⁸⁴⁹

⁸⁴¹ Letter from George I. Loveland, Senior Deputy City Manager, to Ronald R. Blair, Sanitary Engineering Associate (Jan. 8, 2004).

⁸⁴² Letter from George I. Loveland, Senior Deputy City Manager, to Ronald R. Blair, Sanitary Engineering Associate (Jan. 8, 2004).

⁸⁴³ Letter from Ronald R. Blair, Sanitary Engineering Associate, to Michael T. Uberuaga, City Manager (Mar. 17, 2004).

⁸⁴⁴ San Diego City Council Resolution R-299322 (June 8, 2004).

⁸⁴⁵ City Manager's Report No. 04-112, at 1 (June 2, 2004).

⁸⁴⁶ E-mail from Doug Sain to Tom Story (Apr. 23, 2004); E-mail from Kimberly Wilbur to Dick Murphy (May 14, 2004); E-mail from Richard Mendes to Tom Story (May 13, 2004).

⁸⁴⁷ San Diego City Council Resolution R-299322 (June 8, 2004).

⁸⁴⁸ San Diego City Council Resolution R-299322 (June 8, 2004).

⁸⁴⁹ Charles G. Abdelnour, City Clerk of the City of San Diego, California, Certification (of the passage and adoption) of Resolution No. R-299322 by the Council of the City of San Diego on June 8, 2004; Minutes, San Diego City Council Meeting at 14-15 (June 8, 2004). Council members Scott Peters, Michael Zucchet, Toni Atkins, Charles Lewis, Brian Maienschein, Donna Frye, James Madaffer, Ralph Inzunza, and Mayor Murphy voted in favor of the resolution.

On June 15, 2004, Mr. Kahlie transmitted the approved resolution to Mr. Blair, stating he was “pleased” to provide Mr. Blair with the resolution evidencing City Council’s “adoption of the SWRCB-compliant municipal sewer rate structure.”⁸⁵⁰ Mr. Blair responded to Mr. Kahlie’s transmittal in a letter to City Manager P. Lamont Ewell confirming, “[t]he City is in compliance with all Wastewater Revenue Program requirements of the US-EPA CWG Program and the SRF Loan Program.”⁸⁵¹ On October 1, 2004, consistent with the schedule set in the resolution, the City’s new compliant rate structure took effect.⁸⁵²

As Councilmember Madaffer foreshadowed when he declared in closed session, “Let ‘em sue us!,” just days after Council adopted the resolution changing the City’s sewer rates, a lawsuit was filed against the City.⁸⁵³ The action was filed on behalf of a class consisting of residential property owners in the City of San Diego who were charged sewer fees from June 16, 2000, through June 8, 2004.⁸⁵⁴ The lawsuit alleged the City violated both Prop 218 and its grant and loan conditions by not recovering costs for the City’s organics removal.⁸⁵⁵ It further alleged that as a result of these violations, residential customers were charged disproportionately higher rates than commercial customers.⁸⁵⁶ The lawsuit is currently pending in San Diego.⁸⁵⁷ It seeks damages, and could very likely result in the City having to refund past overcharges to residential users. Though he cautioned that the statements in his report not be construed as an admission by the City in the litigation, the City Attorney himself concluded that the City’s noncompliant rate structure caused San Diegans to be overcharged by approximately \$20 million *per year*, from 1998 to 2004.⁸⁵⁸ While

⁸⁵⁰ Letter from Dennis H. Kahlie, Utilities Finance Administrator to Ronald R. Blair, Sanitary Engineering Associate, cc to Assistant City Manager Loveland, Deputy City Manager Frazier, and Deputy City Manager Mendes (June 15, 2004).

⁸⁵¹ Letter from Ronald R. Blair, Sanitary Engineering Associate, to P. Lamont Ewell, City Manager, cc to Richard Mendes, Utilities General Manager and Dennis Kahlie, Utilities Finance Administrator, bcc to Kathy Bare, DFA (June 17, 2004).

⁸⁵² <http://www.sandiego.gov/water/pdf/press/040715.pdf>; www.sandiego.gov/water/pdf/newsewerratefaq.pdf

⁸⁵³ Complaint, *Shames v. City of San Diego*, No. GIC 831539 (Cal. Super. Ct. June 16, 2004); E-mail from Les Girard to Dennis Kahlie cc to Patricia Frazier and Mary Vattimo (Apr. 15, 2004).

⁸⁵⁴ Complaint at 4, *Shames v. City of San Diego*, No. GIC 831539 (Cal. Super. Ct. June 16, 2004).

⁸⁵⁵ First Amended Complaint at 1, 5, 7-8, *Shames v. City of San Diego*, No. GIC 831539 (Cal. Super. Ct. Sept. 21, 2004).

⁸⁵⁶ First Amended Complaint at 5, *Shames v. City of San Diego*, No. GIC 831539 (Cal. Super. Ct. Sept. 21, 2004).

⁸⁵⁷ A Motion to Dismiss the First-Amended Cross Complaint is currently pending. See *Shames v. City of San Diego*, No. GIC 831539 (Cal. Super. Ct. 2006).

⁸⁵⁸ City Attorney Michael J. Aguirre Wastewater Interim Report No. 1 City of San Diego Officials’ Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity, at 1 n.1, 18 (Sept. 15, 2005).

San Diego home owners were shouldering the burden for the City, the industrial users were getting a free ride in the same amount.⁸⁵⁹

⁸⁵⁹ City Attorney Michael J. Aguirre Wastewater Interim Report No. 1 City of San Diego Officials' Failure to Disclose Material Facts in Connection with the Offer and Sale of Wastewater Bonds and Related Improper Activity, at 18 (Sept. 15, 2005).